

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

BILL ANALYSIS

Assembly Bill 1995

Assembly Member Correa (As amended 5/13/02)

Position:

Support (Staff recommendation)

Proponents:

CALPIRG, Center for Public Interest Law, Congress of CA Seniors, Consumer Attorneys of CA, Consumers Union, Foundation for Taxpayer and Consumer Rights

Opponents:

Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, PricewaterhouseCoopers LLP, CA Chamber of Commerce, CA Society of Certified Public Accountants

SUMMARY

Assembly Bill 1995 limits the services a California accountant or accounting firm that certifies corporate financial statements can perform for an audit client. Such accountants or firms could only perform tax preparation services or review Securities and Exchange Commission (SEC) filings in addition to their audit services.

HISTORY

SB 1527 (Burton, 2002) requires accountancy partnerships or corporations registering with the Board of Accountancy to certify that the partnership or corporation will not provide, or will not knowingly have a financial interest in, any non-audit services to an audit client that is a publicly traded corporation.

H.R. 3763 (Oxley) prohibits independent auditing firms from providing internal auditing and financial computer system consulting, but permits tax consulting. Permits the SEC to determine additional prohibited services.

S. 2004 (Dodd—Corzine) prohibits accounting firms from providing external auditing and non-auditing services to a client, but allows the provision of tax consulting services if approved in advance by the auditing committee of a client company's board of directors.

S. 2460 (Levin) prohibits an accounting firm from auditing its own work and from providing non-auditing services to a company during the course of its audit contract and for two years afterward.

BACKGROUND

As a major investor in domestic equity and fixed-income markets, the California State Teachers' Retirement System (CalSTRS) and its investment managers rely, among other things, on corporate financial statements and independent audits performed by outside accountants in order to make informed investment decisions. Accurate financial statements and reliable independent audits are also vital tools in assessing the true value of CalSTRS' investments. The failure of Enron and the role their independent auditor, Arthur Andersen LLP, played in it, exposed the inadequacy of safeguards to protect investors from questionable accounting practices and major conflicts of interest between auditors and their audit clients.

While approximately half the income Andersen generated from its business relationship with Enron was attributed to its role as independent auditor, the other half was generated from the consulting services it provided to the company, such as the development of an automated internal accounting system. Many have expressed concerns that Andersen's duty to accurately reflect Enron's condition in the financial statements it certified was compromised by its effort to improve Andersen's finances by also serving as an accounting consultant to Enron. This practice of providing consulting services to audit clients has become an increasingly common occurrence within the accounting industry and calls into question the independence and objectivity of all independent auditors. From 1993 to 1999, the average annual growth rate for revenues from non-audit services has been 26 percent, while comparable growth rates for audit and tax services have been, 9 percent and 13 percent, respectively over the same period.

Responsibility for the oversight and setting of standards for auditors and the accounting industry is spread among numerous state and federal government agencies and professional organizations. The SEC sets disclosure requirements for securities that are bought and sold in U.S. markets and requires an independent accounting firm audit corporate financial reports annually. The SEC can fine and/or bar accountants from auditing publicly traded companies if they have violated SEC disclosure rules.

The SEC also has the statutory authority to set accounting rules. It has, however, delegated this task to the non-profit Financial Accounting Foundation (FAF). The FAF is run by 16 trustees, the majority of whom are accounting industry representatives. The FAF oversees, funds, and selects the members of the Financial Accounting Standards Board, a 7-member body that sets the rules for how public companies keep their financial records. The American Institute of Certified Public Accountants (AICPA), a professional society, also performs a peer-review function through its ethics division and various oversight committees. However, the most severe disciplinary action imposed by the AICPA is to expel a member from the organization for unprofessional conduct.

Besides regulating most forms of corporate conduct, individual states license accountants and set practice standards. Through statute and regulations, the California Board of Accountancy determines what services an accountant, accounting partnership or accountancy corporation working in the state may provide to a client, specifies what constitutes a conflict of interest, and

establishes disclosure requirements and other rules of professional conduct. It also has the authority to strip an accountant of their license for violating these laws, regulations, and other professional standards, including generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS).

Existing law requires accounting partnerships and corporations that provide auditing services to undergo a structured peer review of their work before they may renew their license or registration. Board of Accountancy regulations also requires accountants that perform auditing services for government and the private sector to take continuing education classes in the subject. Recently, the Board of Accountancy has made matters related to the audit of public companies a priority because members of the Board believe abuses in this area represent the greatest danger to the consumer.

In April 2002, the Board of Accountancy released its Report and Recommendations on Audit Standards and Practices, which addressed four key areas: 1) record retention and working paper documentation; 2) the influence of non-audit services on auditor independence and objectivity; 3) auditors becoming employees of their clients; and 4) auditor's responsibility to detect and report errors and irregularities. The report included proposed legislation that specifically defines what constitutes audit services and also prohibits auditors of public companies from providing specified non-audit services to their audit clients. According to the report, their list of prohibited services would be consistent with SEC rules, adding two non-audit services to the list of prohibited services (information technology systems design and internal audit outsourcing).

Proposals dealing with issues of investor protection, accounting oversight and corporate governance continue to circulate in Congress, state legislatures, the SEC, and self-regulating industry groups. According to CalSTRS' Washington counsel, a consensus on the proper elements of a new regulatory framework has not formed, and the prospects for passage of reform legislation at the federal level remain unclear.

DISCUSSION

Assembly Bill 1995 limits the services a certified public accountant or accounting firm licensed by the state may perform for an audit client to:

- Work performed in the course of forming an opinion regarding financial statements.
- Preparation of tax returns and tax planning advice related to the preparation and filing of returns.
- Review of documents filed with the SEC during the period under audit.
- Attending meetings with a client's audit committee or board of directors, as well as annual shareholders meetings.

- Reissuing audit opinions from prior periods and preparation of documents relating to SEC filings.
- Communications regarding GAAP and other financial reporting issues.
- Responding to regulatory inquiries, including inquiries by the SEC, relative to a client's fiscal period audited by the licensee.
- Communicating with predecessor and successor accounting firms.
- Preparation of management recommendation letters that are an integral part of the audit process.
- Providing testimony to government agencies, legislative inquiries, or in court proceedings regarding audit work performed.
- Other services specified by the state Board of Accountancy that meet specified criteria.

According to the author, AB 1995 responds to an issue exposed by the bankruptcy of the Enron Corporation after its auditor, Arthur Andersen LLP, who also performed non-audit consulting services for the company, revised Enron's financial statements to reflect a major loss over a span of several years. He believes the practice of certifying inaccurate corporate financial statements is not isolated to this incident, and represents a continuing problem within the accounting industry that must be addressed.

AB 1995 generally reflects the recommendations made by the California Board of Accountancy. Rather than prohibiting specified non-audit services and allowing the provision of all other services to public companies, as recommended by the Board, however, AB 1995 specifies the types of non-audit services that can be provided, and bans the provision of all other non-audit services to their public and private audit clients. All the authorized services specified by the bill relate in some way to the performance of independent audits and preparation of tax returns. In addition, AB 1995 applies to a larger group of audit clients by forcing auditors of private companies to follow its requirements, and, by prohibiting the provision of any service not listed, is somewhat more restrictive than the Board's proposal.

In effect, AB 1995 authorizes the California Board of Accountancy to discipline accountants and accounting firms working in California that perform unauthorized services for their outside audit clients up to, and including, the suspension and revocation of their licenses. Because any accountant or firm that works in California or serves California clients must obtain a license from the Board of Accountancy and a licensee working for a California client in another state must continue to follow California law, AB 1995 provides investors a greater degree of comfort in the audited financial statements of California companies. It does not affect, of course, the activities of companies and auditors operating outside of California. As a result, adoption of this proposal at the federal level would be of more widespread effectiveness.

The authorized services specified in AB 1995 are consistent with those permitted by SB 1527. The provisions of SB 1527, however apply only to accounting partnerships and accountancy corporations that provide independent auditing services to publicly traded corporations. Furthermore, AB 1995 specifically permits the Board of Accountancy to expand the list of authorized services under certain conditions, while SB 1527, which also defines audit services and non-audit services, does not. While the two bills differ in their various provisions (being more restrictive in some areas and less in others) both would improve auditor independence to a similar degree.

With the significant change in the role of external audit firms, and internal audit/financial reporting, the CalSTRS Investment Committee and its Subcommittee on Corporate Governance has approved an extensive plan to promote financial market reforms, including strengthening standards related to corporate audit committee accountability, external auditor independence and disclosure. CalSTRS supports limiting the non-audit services that an external auditor provides a corporation to taxation issues, as well as preventing external auditors from directly investing in audit clients and their affiliates. The Investment Committee has amended the CalSTRS Statement of Investment Responsibility to reflect the change, allowing CalSTRS, as a shareholder, to vote against the selection or retention of an external auditor that violates those policies. The provisions of AB 1995 mirror the recommendations adopted by the CalSTRS Investment Committee regarding external auditor independence and provide another means to ensure that external auditors and publicly traded companies comply with CalSTRS' corporate governance policies.

FISCAL IMPACT

Benefit Program Costs – None

Administrative Costs – None

RECOMMENDATION

Support. This bill is consistent with the CalSTRS policy that a corporation should limit the non-audit services it receives as an audit client to taxation issues and advances the System's implementation plan regarding financial market reform. It would, within California, prevent a clear conflict of interest between an independent auditor's duty to investors that need reliable information on the financial state of a company, and their audit client's desire to portray its financial state in the best possible light. A federal limitation, however, is a preferred approach.